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ABSTRACT

Appropriate for secondary school social studies or community programs, this publication considers the issue of taxation in America. The first of five sections, "Taxing Matters," considers the growing perception that the present tax code is unfair and in need of drastic reform. Alternative solutions to the problem are considered. "The Loophole Lobby" looks at the various loopholes, deductions, and exemptions in the present tax code. "Progressive Intentions" examines the principle that those with higher incomes should pay more taxes. "Beyond the Income Tax" investigates methods of taxation other than the federal income tax system. A final section, "The Bottom Line," raises the issue of what compromises citizens are willing to accept in making tax reform. Before and after questionnaires on participants' viewpoints are provided with the materials. Supplementary materials include a reading list, acknowledgements, and materials order form. (LP)

Taxes: Who Should Pay and Why?

When columnist George Will recently remarked that "politics is 95 percent talk," his point was to call attention to the importance in a democracy of a certain kind of conversation. In a truly democratic nation, that conversation cannot be limited to the talking and listening that goes on among elected officials and a small elite of policy advisers.

It is true that the media bring an ample portion of news into our homes, and that allows leaders to speak to us. But it is not enough for us to sit there, passively watching the evening news. Democracy is not, after all, a spectator sport.

Lots of little "publics" called special interest groups are active, vocal, and well organized — and *their* voices are loud and clear enough to be heard. Of course there is nothing wrong with special interest politics. But something important is missing from the conversation of democracy if we talk only to people who share our particular interests, and if political leaders listen only to the petitions of special interest groups.

What is needed is for us to find a way of speaking to elected officials not as representatives of special interest groups but as individuals, as a lobby for the public interest.

That may sound hopelessly naive. It is hard enough for most of us to understand issues to the point of discerning what is in the public interest. It is harder still to believe that anyone is interested in hearing what we think and feel.

That is why the Domestic Policy Association was formed four years ago, to bring Americans together each fall to discuss urgent public issues, and then to share the outcome of those conversations with leaders. The DPA represents the pooled resources of a nationwide network of organizations — including libraries and colleges, museums and membership groups, service clubs and community organizations. The National Issues Forum, which the DPA has organized, provides a nonpartisan forum in which citizens discuss specific policy issues and air their differences.

The goal of the community forums that take place each year under the auspices of the National Issues Forum is to stimulate and sustain a certain kind of conversation — a genuinely useful debate that moves beyond the bounds of partisan politics, beyond the airing of grievances to mutually acceptable responses to common problems.

Each year, the convenors of this nationwide effort choose three issues for discussion. This year's topics are tax reform, the purpose and limits of the welfare state, and U.S.-Soviet relations. There is an issue book like this one for each of the topics. These books are intended to frame the debate by presenting different choices, and the arguments for and against them.

The forum process doesn't end in those local meetings. Each year, the DPA convenes a series of meetings with national leaders to convey the outcome of these forums. One such meeting will take place next March at the Gerald Ford Presidential Library in Ann Arbor, Michigan.

The experience of the past three years indicates that leaders *are* interested in your considered judgment about these issues. We have provided an issue ballot at the beginning and end of this book. With these two ballots, we can help leaders to understand what they are most interested in knowing — how initial thoughts and feelings about an issue differ from the more considered judgment that people reach after thoughtful discussion. Before you begin reading and after you have attended community forums and given some thought to the issue, I urge you to fill out these ballots and mail them back to us.

So, as you begin this issue book from the Domestic Policy Association, you are joining thousands of Americans in the fourth annual season of the National Issues Forum. As the editor of these issue books, I am pleased to welcome you to this common effort.

Keith Melville

Keith Melville
Editor-in-Chief
The National Issues Forum

NATIONAL ISSUES FORUM

1. Taxes: Who Should Pay and Why?

One of the reasons why people participate in the National Issues Forum is that they want leaders to know how they feel about these issues. The Domestic Policy Association has promised to convey a sense of your thinking on the topic of tax reform both locally and at the national level. In order to present your thoughts and feelings about this issue, we'd like you to fill out this short questionnaire *before* you attend forum meetings (or before you read this issue book, if you buy it elsewhere), and another short questionnaire — which appears at the end of this issue book — after the forum (or after you've read this material).

The leader at your local forum will ask you to hand in this ballot at the end of the forum sessions. If it is inconvenient to do that, or if you cannot attend the meeting, please send the completed ballot to the DPA in the attached envelope. In case no envelope is enclosed, you should send this ballot to the Domestic Policy Association at 5335 Far Hills Avenue, Dayton, Ohio 45429. A report summarizing participants' views will be available from the DPA next spring.

PART I

For each item below, check the appropriate box to indicate whether it is something you favor or oppose.

	Favor	Oppose	Not Sure
1. Use income tax deductions to encourage people to own their own home, give to charity, and accomplish other social goals **PRO:** Using income tax deductions enables the government to encourage people to spend their money in ways that benefit the whole society. **CON:** The income tax should have only one purpose — to pay for what the government does.	☐	☐	☐
2. Grant income tax exemptions for people in special circumstances **PRO:** It is only fair that the blind, the disabled, and those with many dependents should pay less tax than those in good health or with no children. **CON:** Those who earn the same should pay the same amount of tax, regardless of circumstances.	☐	☐	☐
3. Provide preferential tax treatment to certain businesses and industries as an incentive to investment and growth **PRO:** Economic growth is in everyone's interest; preferential tax treatment for certain businesses and industries enhances growth. **CON:** Many preferences designed to promote growth don't have the intended result; instead, they end up as costly loopholes that burden everyone else.	☐	☐	☐
4. Eliminate all income tax deductions for individuals **PRO:** The idea has been abused to the point of excess; most of the deductions favor those in the highest income brackets. **CON:** Providing incentives is one of the things the government does well. It is a way for the government to achieve social goals without directly interfering in the economy or people's lives.	☐	☐	☐

PART II

Here are five types of tax systems:

a. A *very regressive* system taxes those who earn the least at substantially higher rates.
b. A *somewhat regressive* system taxes those who earn the least at slightly higher rates.
c. A *flat tax* system taxes everyone at the same rate, regardless of income.
d. A *somewhat progressive* system taxes those who earn the most at slightly higher rates.
e. A *very progressive* system taxes those who earn the most at substantially higher rates.

5. Which best describes what percentage of their total income people *actually pay* under the existing laws?

a. Very Regressive ....☐
b. Somewhat regressive ....☐
c. Flat ....☐
d. Somewhat progressive ....☐
e. Very progressive ....☐
f. Not sure ....☐

PART II (Continued)

6. Which best describes the major tax reform proposals now being discussed in Washington?

a. Very Regressive ☐	d. Somewhat progressive ☐
b. Somewhat regressive ☐	e. Very progressive ☐
c. Flat ☐	f. Not sure ☐

7. Which best describes what percentage of their total income people *ought to pay* in a fair system?

a. Very Regressive ☐	d. Somewhat progressive ☐
b. Somewhat regressive ☐	e. Very progressive ☐
c. Flat ☐	f. Not sure ☐

PART III

For each item below, check the appropriate box to indicate if it is something
a. we should *do now*
b. we should do *only if* taxes have to be raised
c. we should *not do* under any circumstances

	Should Do Now	Only If	Should Not Do
8. Should we require corporations to pay income taxes at rates that are at least as high as most of the rates paid by American families?	☐	☐	☐
9. Enact a federal sales tax with exemptions for certain necessities such as food and medicine	☐	☐	☐

(Question 8)

PRO: Some corporations make huge profits and pay no tax at all; a business that prospers should pay at least some tax.

CON: Raising corporate taxes only takes away money that would otherwise be invested or go to employees and stockholders, and thereby benefit everyone.

(Question 9)

PRO: In addition to being easy to collect, such a tax would be hard to avoid and would bring in substantial new revenue.

CON: Such a tax would be both inflationary and regressive, falling most heavily on low- and middle-income people.

PART IV

10. If the federal government had to raise taxes substantially, which would be a better way to do it — by increasing individual income taxes, or imposing a new national sales tax on purchases other than food?

Increase income taxes ☐
Impose federal sales tax ☐
Not sure ☐

11. Compared to other taxpayers, are the taxes you pay:

Too high ☐	Too low ☐
About right ☐	Not sure ☐

PART V

12. Did you participate in a DPA forum *last* year?
Yes ☐
No ☐

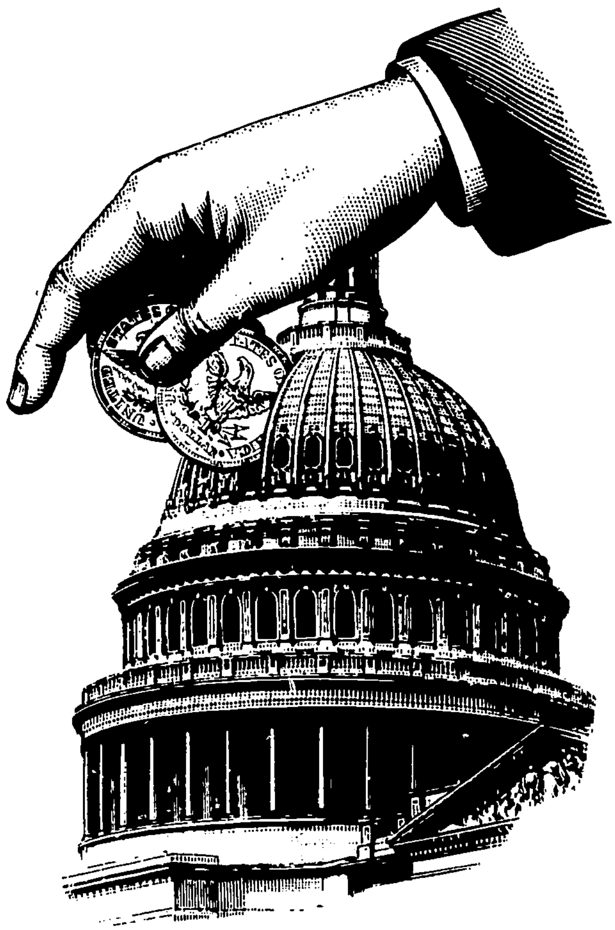
13. Did you (or will you) participate in DPA forums on other topics *this* year?
Yes ☐
No ☐

14. What is your zip code? .... ________

15. Which of these age groups are you in?
Under 18 ☐ 45 to 64 ☐
18 to 29 ☐ 65 and over ☐
30 to 44 ☐

16. Are you a man or a woman?
Man ☐
Woman ☐

NATIONAL ISSUES FORUM



Taxes: Who Should Pay and Why?

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The Domestic Policy Association

The Domestic Policy Association is a nonprofit, nonpartisan association devoted to raising the level of public awareness and discussion about important public issues. It consists of a nationwide network of institutions — colleges and universities, libraries, service clubs, membership groups, and civic organizations — that bring citizens together to discuss public issues. The DPA represents their joint effort to enhance what they already do by working with a common schedule and common materials. In addition to convening meetings each fall in hundreds of communities in every region of the country, the DPA also convenes meetings at which it brings citizens and national leaders together to discuss these issues and the outcome of community forums.

Each year, participating institutions select the topics that will be discussed in the issue forums. On behalf of the Domestic Policy Association, the Public Agenda Foundation — a nonprofit, nonpartisan research and education organization that devises and tests new means of taking national issues to the public — prepares issue books and discussion guides for use in these forums. The Domestic Policy Association welcomes questions about the program, and invites individuals and organizations interested in joining this network to write to: The Domestic Policy Association, 5335 Far Hills Avenue, Dayton, Ohio 45429.

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Contents

1

Taxing Matters

> There is a growing perception that the tax code is unfair and unmanageably complex, and in need of drastic reform. But can a consensus be reached about what should be done?

The State of the Union Address is traditionally an occasion for the President to identify priorities on the nation's agenda. It was no coincidence this past February that the first issue President Reagan addressed — before war and peace, before the economy, before education and crime — was taxes.

Previously, the President criticized the tax system as "unfair, inequitable, counterproductive and all but incomprehensible," and he wasn't the first President to do so. Jimmy Carter called the tax code a "disgrace to the human race." That's a curious situation, two Presidents publicly disparaging a tax system that depends on public support to fund the programs of the federal government.

In his State of the Union Address to Congress, President Reagan did something more than point to the inadequacies of the existing tax system. He urged fundamental reform. "Let us move together with an historic reform of tax simplification for fairness and growth." The President spoke approvingly of the Treasury Department's "excellent reform plan whose principles will guide the final proposal that we will ask you to enact."

Considering the radical surgery that the Treasury Department was proposing, this was quite a remarkable endorsement. If enacted, the Treasury plan would drastically change the tax codes by wiping out most of the tax breaks that are now included in the IRS code. In exchange, the Treasury would put in place a simpler tax system, with lower rates and fewer brackets.

Among the members of Congress to whom the President spoke in February, support for radical tax reform has been voiced from both sides of the aisle. Representative Jack Kemp (R-NY), the coauthor of one major tax reform proposal, made the case against the current system in these words. "The system fails, and fails miserably, on the criteria of equity, efficiency, and simplicity. It is a monstrous system that cries out for major overhaul. Piecemeal reform will only paint over a foundation that is cracked and flawed to its core."

Senator Bill Bradley (D-NJ), the coauthor of another major tax reform package said, "There is a widely shared perception that the tax rates are much too high, that the Internal Revenue Code is extremely complex. When most people get the IRS booklet their response is, 'I'm not using most of these deductions, but somebody is, and I end up paying too much.' The country is ripe for reform."

This is certainly what the polls suggest. A complicated tax code with higher rates has precipitated a rapid decline in public esteem for the federal income tax. As recently as 1972, most Americans considered the income tax to be the fairest tax in the country, in comparison with federal excise taxes, state sales and income taxes, and local property taxes. Since then, however, trust has plummeted. Over the past few years, most Americans have come to feel that the federal income tax is this country's least fair tax.

Public discontent with the tax code is one of the factors that has contributed to an epidemic of cheating. About $100

MacNelly. Reprinted by permission: Tribune Media Services

billion in taxes is not paid each year because of illegal evasion and honest mistakes by confused taxpayers. The recognition that many people are evading their taxes prompts others to fudge on their returns, thus spreading disrespect both for the system and for the government it finances.

Significantly, several commissioners of Internal Revenue have been highly critical of the current system. "I am not hearing just vague rumblings of discontent," said Roscoe L. Egger, Jr., the current commissioner. "People are really fed up with the system's unequal treatment of people and corporations, its complexity, and its loopholes for the well-advised and well-heeled. Tax reform is a stark necessity."

Simplicity and Fairness

There is widespread agreement that something should be done. But what? We agree about the need for a system that is fair, simple, and helpful to the economy. But affirming such values doesn't get us very far, because different people disagree about what those values mean.

Everyone wants a fair system. But if a fair system means that families at the same income level pay equal taxes, should it matter that one family has more children, emergency medical bills, an infirm grandmother, and a house that recently suffered extensive fire damage? If fairness means that lower-income families should pay less in taxes, how much less?

The goal of simplicity poses a similar problem. When so many decisions are made with an eye to their tax implications, and when four out of ten taxpayers require professional assistance to fill out their tax forms, it is not hard to agree that the tax system has become too complex. Of course we would like a tax code that is easy to understand and easy to enforce. But what is simple is not necessarily fair. Consider, for example, one idea that no one has proposed, a "head tax" — the simplest of taxes, requiring the same amount from everyone. Because it does not take into account people's ability to pay, a "head tax" would be regarded by most people as manifestly unfair.

No tax plan can at once be perfectly fair, utterly simple, and economically neutral. In a search for the best combination of these elusive, and at times incompatible goals, we have to face some hard choices and untidy trade-offs.

Randy Matusow/Archive

Three Choices

By the spring of 1985, several tax reform packages had been proposed in Congress, and each represents a different mix of these goals. In addition to the Treasury plan, the leading reform proposals include the Bradley-Gephardt plan and the Kemp-Kasten bill. The goal of these proposals, and others that have been introduced in Congress, is not to raise additional taxes but rather to maintain the current level of revenues with a simpler and fairer tax system.

As citizens and taxpayers we have certain practical questions about these proposals. We want to know how they differ from the current income tax. People wonder how tax reform would change the distribution of the tax burden, and whose tax deductions would be eliminated.

Despite the considerable media attention that has been devoted to tax reform, it is difficult to find clear answers to these questions. Because this debate contains some forbiddingly technical terms, it is often hard to follow. Tax bills are laden with unfamiliar terminology such as "fractional exclusion rates" and "wage exclusion scales." Analysts contrast "marginal" tax rates with "effective" rates.

However, the underlying choices can be stated simply enough, and these provide a framework for our discussion of tax reform. The first choice is whether the tax system should contain an extensive network of incentives in the form of tax shelters and deductions. One of the marked changes in the tax code over the past several decades has been the increasing numbers of exceptions and exemptions for special categories of taxpayers. Whether their purpose is to encourage charitable contributions or oil exploration, there is a reason for each loophole. Altogether, however, these loopholes make the tax code far more complex, and they are the source of much resentment and confusion. In the name of simplicity and fairness, should such loopholes be eliminated?

We could repeal such tax breaks and use the tax system strictly as a means of collecting government revenues. Or, if we agree that some of these incentives serve the public interest while others do not, some could be preserved. The discussion in section two focuses on how the tax system is used to accomplish certain social and economic goals, and examines what is sacrificed in fairness and simplicity when the tax system is used for such purposes.

A second choice is how to distribute the tax burden among people at different income levels. Although most Americans agree with the principle of a progressive system — that people with higher incomes should pay higher tax rates than the rest of the population — people differ about how much more they should pay. Are the "modified flat" taxes now being proposed progressive enough?

Finally, there is a third choice, about the sources of federal revenue. Have we come to rely too much on the income tax? There are, after all, various ways in which revenue could be raised. One option is to place a heavier tax burden on corporations. It is common to hear complaints that corporations are not currently paying their "fair share." But what constitutes a "fair share" remains an open question. Another possible source of revenue is a national sales tax or some other type of consumption tax. Taxing consumption as well as income would amount to a significant change in federal tax policy, but perhaps it is a change worth considering. The question is which additional revenue sources should be tapped.

"The tax system has come to mirror Washington itself: a complicated, frustrating, unfair mystery of legalistic gobbledygook and loopholes never designed, it seems, to help everyday wage earners, only those who can afford high-priced attorneys and accountants."

—President Ronald Reagan

High Stakes, Heated Debate

These various proposals present the best opportunity in years for a serious national discussion of fundamental issues of tax policy. "This isn't just another tax bill," observed John Albertine of the American Business Conference. "It is a seminal economic and political issue." It is likely to be one of the most prominent domestic policy issues over the coming months.

Tax collection is one of the fundamental tasks of government, the one that makes other government programs possible. As Senator Bradley put it earlier this year, "What issue affects over 100 million Americans directly, other than war and peace?" He characterizes the battle over tax reform as "a complicated and fascinating drama," and so it is. On one level, the drama results from conflicting conceptions of which proposals best serve the public interest. On another level, the drama is between those who advocate radical tax simplification and those who favor the current system. It is one thing for the President to say that we should "move together with an historic reform of tax simplification for fairness and growth"; it is quite another to accomplish such sweeping reform.

The eye-glazing pages of the tax code may not look like they would provoke a fight, but almost every paragraph has its defenders. The Treasury proposal, for instance, would eliminate many of the tax deductions that individuals and corporations use to lower their taxable income. On individual taxes, the Treasury plan would limit the deduction for fringe benefits and the special low tax rates that apply to profits from the sale of a home, or stocks owned a long time. For corporations, it would eliminate the tax preferences that they currently receive on capital investments. And these are just a few of the sweeping changes that have been proposed.

Fearing that tax reform would not be in their interest, individuals and corporate groups have mobilized to protect their interests, to convince members of Congress that their concerns coincide with the public interest. Much of what has been said about tax reform since the debate began in earnest this past spring represents the arguments of one group or another about why they should not be expected to bear so much of the tax burden. It represents the special pleadings of a great variety of groups, and provides an illustration of the wry formula that Senator Russell Long (D-La.), an influential member of the Senate tax committee, is fond of repeating, "Don't tax you, don't tax me, tax that guy behind the tree."

Throughout the spring and summer of 1985, many of the groups with a stake in the tax laws stepped forward to defend their interests. There is nothing wrong with such a process. In a democracy, petitioning the government is one of our basic rights. Yet a working democracy assumes that the decisions Congress makes will not favor specific interests at the expense of the public interest. The health of a democratic nation requires a concerned majority that will tip the scales on the side of the general welfare, the common good. Whatever reforms take place in our tax codes, they are more likely to be fair if elected representatives hear the considered judgment of thousands of ordinary citizens who constitute a lobby for the public interest.

So our purpose is to provide a framework for public discussion of tax reform, and to stimulate debate about which measures best serve the public interest. Fundamental questions are being asked about how the burden of raising over $700 billion in federal revenues should be distributed. Redesigning the tax system is a matter in which we all have a stake as citizens and taxpayers. It is a matter in which we should all have a say.

2

The Loophole Lobby

> **"The road to a tax code riddled with deductions and exemptions is paved with good intentions, but good intentions do not necessarily lead to sound tax policy. Should the loopholes be eliminated?"**

If you are interested in understanding why radical tax reform is likely to be quite difficult to accomplish, despite widespread dissatisfaction with the existing IRS rules and the President's strong endorsement of tax simplification, there is no better vantage point than Room 1100 in the Longworth House Office Building in Washington. That is where, beginning in the spring of 1985, the House Ways and Means Committee conducted a series of standing-room-only hearings on tax reform.

Trying to decide which tax reform proposals they should support, committee members invited testimony from people who wanted to comment on the proposed plans. It soon became clear that the list of people who wanted committee members to hear their view was quite long indeed. Realtors and home builders came to testify about the adverse impact that tax reform would have on home buyers and renters. Members of the committee heard views expressed by representatives of charity organizations, oil and gas firms, the banking and construction industries, and labor unions. They also heard from representatives of the insurance industry, the steel and auto industry, the airline industry, and college presidents, state government officials, restaurant owners, pension administrators, and mayors. A great many groups with a claim on some section of the tax code were prepared to do battle, leading to one of the most broad-based lobbying campaigns in recent memory. The hearings proved, as one wit observed, that "it's impossible to iron all the wrinkles out of the tax code without scorching someone's shirt."

At issue are more than 100 provisions of the tax code that are technically referred to as tax expenditures, and more popularly known as loopholes. They are special provisions that have been added to the tax code over the years to provide an incentive to certain activities or relief to certain taxpayers. They consist of tax credits, exclusions for certain kinds of income, and deductions for costs beyond what is strictly required to earn income. The tax reductions caused by these provisions are so substantial that the total revenues lost through these loopholes — a sum which came to $340 billion in 1984 — is almost as large as the total revenues collected from the income tax.

In recent years, both taxpayers and lawmakers have come to regard loopholes as unfair. A study by a Washington-based group called Citizens for Tax Justice stated that between 1981-83, "Sixty-five major corporations earned $49.5 billion in profits and paid not one penny in federal income taxes."

It isn't just the nation's businesses that are using tax loopholes to reduce their tax liability. Contrary to public perception, the largest portion of the benefits from loopholes goes to families and individuals. The mortgage interest deduction, for example, provides tax advantages to many middle-class Americans at a current cost to the Treasury of about $27 billion. Individuals as well as corporations, said Senator Lloyd Bentsen (D-Tex.), are "making vast sums of money and paying no taxes through excess use of tax preferences. I say excess because I think when they do it to that extent, it begins to destroy confidence in the

"Just because the I.R.S. might be cracking down on some tax shelters doesn't necessarily mean they're going to be cracking down on your tax shelter."

system. I think anyone making money — a corporation or an individual — ought to pay their fair share of the taxes."

The Roots of Complexity

Stories of individuals and corporations which use deductions and exemptions to reduce their taxes drastically make one wonder why such loopholes were allowed in the first place. After all, this nation started out with a fairly simple revenue system whose sole purpose was to raise the funds needed to run the government. Then the tax system came to be used for other purposes. It is within Congress' power not only to levy taxes, but also to make certain exemptions when there is reason to do so. On many occasions over the past half-century, the members of Congress have chosen to do just that.

Early on, Congress decided that it was in the public interest to encourage gifts to churches, schools, and charities, so a tax deduction for charitable contributions was written into the law in 1917. Just a year later, in 1918, Congress legislated special tax incentives for another group — the oil industry — to assure an ample supply of that important resource during World War I. Some years later, Congress saw a need to stimulate economic growth, so a tax cut for the purchase of new machinery was inserted into the law. And these are just a few of the items on that list of exemptions and deductions. "Once you start down the road of giving tax breaks," said John Chapoton, a former tax policy adviser at the Treasury Department, "it's almost impossible to stop. Each one makes the next one easier."

The results of that process are distilled into the tax booklet that is sent out early each year to millions of American house-

The Tax Expenditure Bill

These are some of the more expensive deductions that individuals and businesses are allowed to subtract from their taxable income. Each deduction comes with a price tag—the cost to the government in taxes which would have been collected had the item not been allowed. The total bill in fiscal year 1986 will come to about $400 billion.

Personal Tax Breaks
Cost to the Government
in FY 1986 (in billions)

Pension contributions by employers	$55.0
State and local taxes	$35.3
Home mortgage interest expenses	$27.3
Medical insurance from employers	$23.7
Capital gains	$19.2
Consumer interest expenses	$15.9
Charitable contributions	$15.1
Individual retirement accounts	$13.4
Social Security benefits	$13.3
Two-earner married couples	$ 7.2
Interest earned on life insurance	$ 3.6

Business Tax Breaks
Cost to the Government
in FY 1986 (in billions)

Most of these deductions for businesses are justified in the name of enhancing the efficiency of the economy or helping industries that are particularly vital to the national interest.

Depreciation of buildings and equipment	$26.7
Purchase of new equipment	$22.0
Oil drilling	$ 5.5
First $100,000 of income	$ 5.3
Research and development expenses	$ 4.8
Leasing equipment or buildings	$ 1.9
Borrowing for industrial/commercial development	$ 1.5
Operation in overseas U.S. territories	$ 1.5
Charitable contributions	$ 1.2
Exports	$ 1.0
Banks' reserves	$ 0.9

holds. As a result of the tendency of congressional committees to grant additional tax favors, the return has become increasingly complicated. In addition to the two-page summary, the 1984 return offers numerous supplementary forms, most of which are provided to allow taxpayers to claim tax credits and deductions. One of the first lines on the tax form provides a reduction for anyone who is blind or over 65. After a taxpayer adds up all income sources, the tax return allows the filer to adjust the income and the tax by using deductions for individual retirement accounts (IRAs), moving expenses, employee business expenses, alimony payments, and other activities that have been granted special tax treatment.

Allowing special tax breaks is one way in which members of Congress respond to their constituents' needs. It is appealing because it does not require new spending appropriations. But it means lost revenues, and that leads to higher taxes for everyone else.

The tendency of Congress to approve so many tax breaks has produced a tax code with more exceptions, it seems, than rules. Numerous exemptions are one of the chief reasons why the tax system is so complex. People tend to distrust what they don't understand, and very few Americans understand all 2,135 pages of the tax code, not to mention some 10,000 additional pages of regulations and court rulings. The multiple layers of its provisions often require extensive record keeping, and they force the IRS to make special interpretations and guidelines to define the limits of each loophole. Yet because of political pressures for additional tax breaks, over time the Internal Revenue Codes have become even more complex. As one Treasury official observed, "You don't go to the Ways and Means Committee or the Senate Finance Committee to simplify anything."

Proponents of tax simplification believe that a strong case can be made for eliminating most, if not all of these deductions and exemptions. "I don't want the tax code for social engineering or for political favoritism," said Senator Bradley. "I want the tax code to raise revenue for the government."

Congress could, of course, cut down on the number of deductions allowed, or eliminate them entirely. In doing so, it could lower tax rates substantially without reducing overall revenues. But is this something that should be done? If you listened to the testimony in Room 1100 of the Longworth House Office Building, you would hear the case that is made for retaining many of those exemptions and deductions. Since decisions need to be made about which — if any — of these loopholes should be allowed, this is a case worth listening to.

Give Me Shelter

Within a few hours after the Treasury Department announced its tax reform proposal late in 1984, and again at the congressional hearings this past spring, defenders of the existing deductions and exemptions were out in force. Because the Treasury

proposal threatens to curtail the tax break for depreciation of buildings and to eliminate other shelters that have channeled investment dollars into real estate, spokesmen for the realty and home builders' industry were sharply critical of it, characterizing the proposal as an obstacle to economic growth. The Treasury proposal would also eliminate a 1981 tax break that allows industries to write off over a few years the cost of plant, equipment, and real estate, even though they continue to be used for many years to come. The head of U.S. Steel called the proposal "regrettable," and said that changing the tax depreciation rules would have an adverse effect on basic industry. The spokesman for a group of restaurant owners warned that removing the tax deduction for business lunches would hurt not only restaurant owners but also their employees such as waiters, busboys, and cooks.

Listening to such statements, you begin to understand why the deductions were created in the first place. In the words of former Representative Wilbur Mills (D-Ark.), who directed tax legislation during his tenure as chairman of the Ways and Means Committee, "There's been a lot of demagoguery about tax subsidies. But every one of them had a purpose and helped somebody, or we wouldn't have put it there."

Many tax breaks represent well-intentioned incentives. For example, Congress grants a tax deduction for IRAs to encourage savings toward financial security in retirement. One of the chief reasons why employers provide pensions for seven out of ten workers is because of the special tax break that encourages companies to fund retirement plans.

To stimulate donations to charities, colleges, museums, and other nonprofit institutions, Congress created other incentives. Charities feel that if their tax break is eliminated the result will be a sharp decline in donations. Said the president of one small college, "In everything we do as fund raisers, we point out to prospective donors the tax benefits of giving. It's built into the fabric of philanthropy." Similarly, according to the officials who run state housing agencies, the elimination of tax breaks for real estate investors would raise the cost of low-income housing. Their argument is that since providing adequate housing is in the public interest, it is also in the public interest to maintain tax breaks as incentives for real estate investors.

Exemptions and deductions are also used to stimulate the nation's economy. One reason for enacting tax incentives for individual retirement accounts was that the money deposited would provide larger pools of capital and thus lower interest rates. In turn, lower interest rates should lead to greater investment and to more rapid economic growth.

Members of the Ways and Means Committee sometimes regard the creation of economic incentives as their chief goal. As one member of the committee said in 1980, "I hear so much in this room about our 'search for equity.' Quite frankly, I don't think that should be the role of this committee. Maybe it should be a second or third priority. But our primary role should be to create incentives through the tax code."

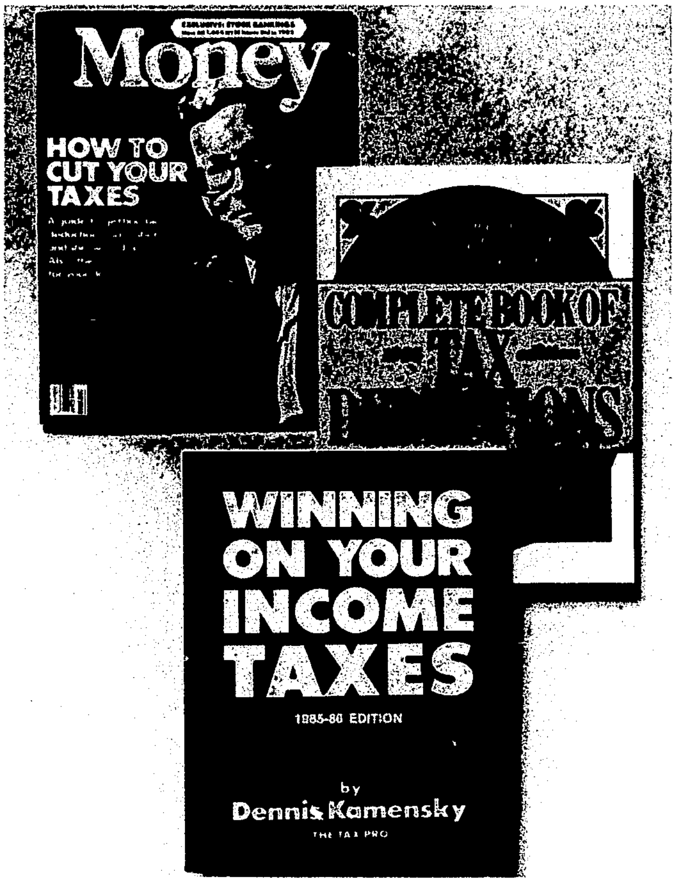


Photo by John Hugelmeyer

An entire industry has grown up to help people turn the tax laws to their advantage.

Still, the explicit purpose of some tax breaks is to enhance equity by trying to make the system fairer for the poor and the disadvantaged. For example, a tax reduction is available for the blind and those over 65, and it saves them $2 billion in taxes each year. Households facing large uninsured medical expenses use special deductions to reduce their taxes by some $3 billion. Another tax break protects most unemployment benefits from taxation, saving these beleaguered families some $2 billion in taxes. In other words, a collective decision has been made to compensate individuals for their difficulties, and tax deductions provide a relatively straightforward way to achieve that goal.

Proponents of incentives warn that tax breaks have such a pervasive influence that eliminating them could cause serious and widespread disruption. The National Association of Realtors estimates that the Treasury's tax reform plan could cause residential rents to increase by as much as 40 percent. And the value of a $150,000 home might drop as much as $20-30,000. Repeal of the tax credit for child care expenses might force some single parents to quit work and to apply for welfare. Elimination of the tax break for medical insurance could deprive some families of adequate medical coverage.

Perhaps that risk is not worth taking to achieve the con-

venience of a simpler tax code. It is one thing to examine tax breaks on a case-by-case basis and discard those that are unworthy or outdated. But wholesale elimination of all tax breaks, some feel, would sacrifice the social and economic objectives this system has achieved.

The Other Pork Barrel

The road to a tax code riddled with loopholes is paved with good intentions. But do those good intentions lead to sound policy? Proponents of radical tax simplification are convinced that however well-intentioned these deductions and exemptions are, their overall effect is perverse.

Critics of tax deductions feel that the tax expenditure pork barrel now rivals the more commonly acknowledged excesses of the pork barrel on the spending side. The logic of politics is that if anyone has a special shelter, everyone has a right to a shelter. As certain groups receive special consideration, others see no reason to refrain from asking for the same treatment. The members of Congress to whom these pleas are made are under more pressure to say yes than to say no. Increasingly, they have said yes. In 1967, loopholes were worth $37 billion. By fiscal year 1985, their total value added up to $370 billion.

"The existing tax system is encrusted with an incredible number of barnacles — tax breaks and loopholes that have accumulated over the past 70 years. The lure of tax advantages distorts economic decision-making and leads to gross inequities among individuals and industries."

—Leonard Silk, economic columnist, the *New York Times*

At best, this explosion of tax breaks has taken place without conscious design. At worst, it is symptomatic of first-come-first-served politics. In either case, critics feel that the system of exemptions and deductions has evolved without any regard for its long-term effects on fairness, efficiency, or simplicity.

The argument for eliminating loopholes begins with the conviction that many of these tax incentives are ineffective in achieving their intended goal. A study by Citizens for Tax Justice charges that "the evidence is overwhelming that 'tax incentives' have been a colossal failure as an economic strategy." In fact, the report alleges, after the 1981 enactment of investment incentives, business investment in new plants and equipment declined in three successive years for the first time in the postwar era.

Similar questions have been raised about the effect of other tax incentives. Will oil firms cease their exploration without a tax incentive? Will companies refuse to expand without tax breaks? With tongue in cheek, former Representative Wilbur Mills once remarked "I don't know how companies survive sometimes. They seem to have no brainpower. They won't do anything smart unless we give them a tax break."

Because of loopholes, people at similar income levels pay quite different tax rates. Moreover, as a recent report from the congressional Joint Economic Committee shows, tax breaks strongly favor the wealthy. The study found, for example, that taxpayers who earn $50,000 or more received 94 percent of the benefits from the tax exclusion for state and local bonds. The same upper-bracket taxpayers received 86 percent of the savings from energy conservation tax credits, two-thirds of the benefits

Tax Evasion

Over 2,000 years ago, Plato wrote in the *Republic* that "when there is an income tax, the just man will pay more and the unjust less on the same amount of income." For several decades after the income tax system was put into effect in 1913, it was a matter of duty and pride for most Americans to act like Plato's "just man." By and large, people paid what they owed. Cheating on taxes was considered reprehensible, and no more socially acceptable than robbing the church poor box.

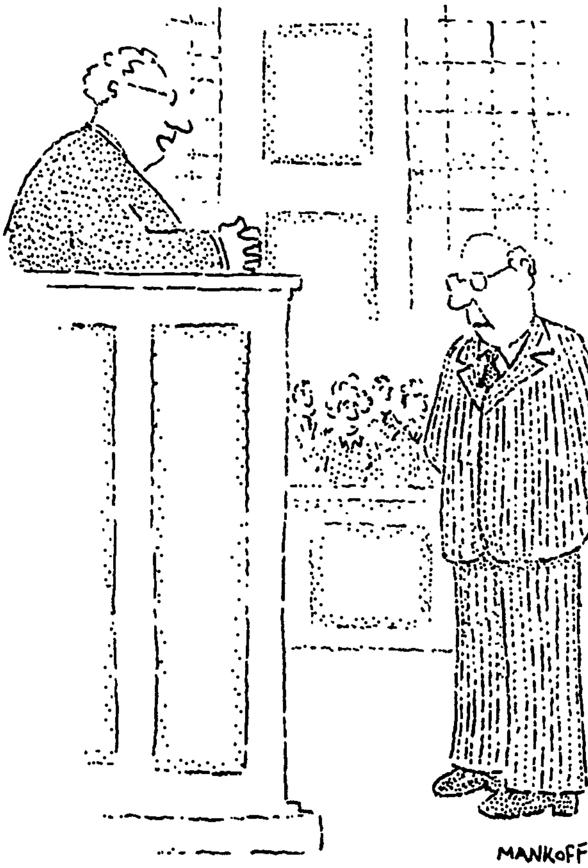
In recent years, however, cheating on taxes has come to be regarded in a wholly different light. By underreporting income or exaggerating allowable expenses, millions of Americans — including a great many who are otherwise law-abiding citizens — manage to evade taxes they are obliged to pay. Paying one's taxes is now widely regarded as a game in which the objective is to beat the system. If you reduce your taxes by bending the rules, that is considered acceptable. After all, isn't everyone else doing the same thing?

The decline in tax compliance has created a huge and costly problem. In 1985, the IRS estimates that the federal government will lose $100 billion in uncollected taxes. That is equal to roughly one-third of the federal deficit.

The American public is increasingly cynical about the matter. More than half of the respondents in a recent Yankelovich, Skelly and White survey said that tax cheating is becoming more common these days. And nearly one in five taxpayers admitted to having cheated on taxes.

Why are so many people inclined to cheat? For one thing, it is considered a way of getting even with a system that provides unfair tax advantages to certain groups. Also, most people assume they can get away with it — which is generally true in a system where only about 1 percent of all returns are audited.

Media accounts tend to focus on the tax cheating that takes place in the "cash economy" where underreporting income is easy — among waiters, cabdrivers, and domestic workers, for example. But tax evasion is an activity in which a great many Americans participate. In fact, the biggest tax evaders are those at middle- and upper-income levels such as doctors, lawyers, landlords, and businessmen. The IRS estimates an annual loss of $26 billion in unreported income from business activities, and another $9 billion from unreported capital gains.



"You're a disgrace to your tax bracket."

Drawing by Mankoff, © 1985. The *New Yorker* Magazine, Inc.

What can be done about this epidemic of tax cheating? Since the very complexity of the current tax laws makes compliance more difficult, a simpler tax system would no doubt encourage compliance. The elimination of deductions that are perceived to be unfair would be a step in the direction of a system that commands respect for its fairness. One of the chief criteria in judging tax reform proposals should be the extent to which they discourage evasion.

But the source of the problem is the public's attitude toward the revenue system. In a democratic society, no tax system will work unless it commands widespread public support. Ultimately, tax evaders steal not from a faceless and distant government but from their honest neighbors, who end up paying more because others pay less.

The Most Uncharitable Cut of All?

Last year, Americans donated over $60 billion to charity. These donations, made to a great variety of institutions — museums and universities, conservation groups, theater companies, hospitals, churches, and soup kitchens — were all tax deductible. One of the reform proposals currently under discussion is the reduction or elimination of deductions for charitable contributions, a proposal that has provoked protests from organizations dependent upon such donations. In summary form, here are the opposing views on the three main issues in this debate.

A tax break for charitable contributions is a fair and efficient way to achieve a desirable goal.

Pro: The institutions supported by those donations deserve public support, especially at a time when government spending in certain program areas is being cut back.

Con: No one disputes the importance of charitable groups. However, offering tax deductions for charitable deductions is unfair because it mainly benefits well-to-do families that can afford to donate money without a tax break.

Tax deductions provide a necessary incentive to charitable contributions.

Pro: If this deduction were eliminated, some donors would reduce their contributions, and others would not make such contributions at all. Charitable groups feel that without this incentive, donations would decline by at least 10 percent, cutting their resources by $6 billion.

Con: Americans make such donations from their heart, and not mainly because of tax considerations. Some contributors would make larger contributions to nonprofit groups to cover their losses if the deduction for charitable contributions is eliminated.

There are other, more direct ways in which government could subsidize charitable groups.

Pro: Charities could be subsidized directly. The federal government could agree to match every donation to charity with a contribution equivalent to what it now gives indirectly through tax breaks. Under this arrangement, charities would still be subsidized, but without the inequities of the current system.

Con: Direct government funding of charities would not succeed in practice. Nearly half of all private donations go to churches, and the constitutional separation of church and state prohibits direct government funding to churches.

from the tax exclusion for long-term capital gains, and more than half of the benefits provided by the deduction for charitable contributions.

Another example of the effects is provided by a recent survey of the people who have taken advantage of IRAs. If the individual retirement account is an idea whose time has come, it has not come to individuals with modest incomes who could benefit most. While more than 60 percent of households with income over $50,000 have IRAs, less than one-quarter of the families in the $20-25,000 range take advantage of this shelter.

Some feel that loopholes create inequities among America's businesses too. In an equitable system, corporations at similar profit levels would pay similar taxes. Yet special exemptions, deductions, and credits make the code inequitable. Because special tax breaks exist for certain industries and not for others, tax rates range from a low of negative 1 percent for the chemical industry — meaning the industry received money from the government rather than the other way around — to a high of 34 percent for the trucking industry. In effect, certain industries are subsidized by the government, and as a result are in a favorable position to attract investors.

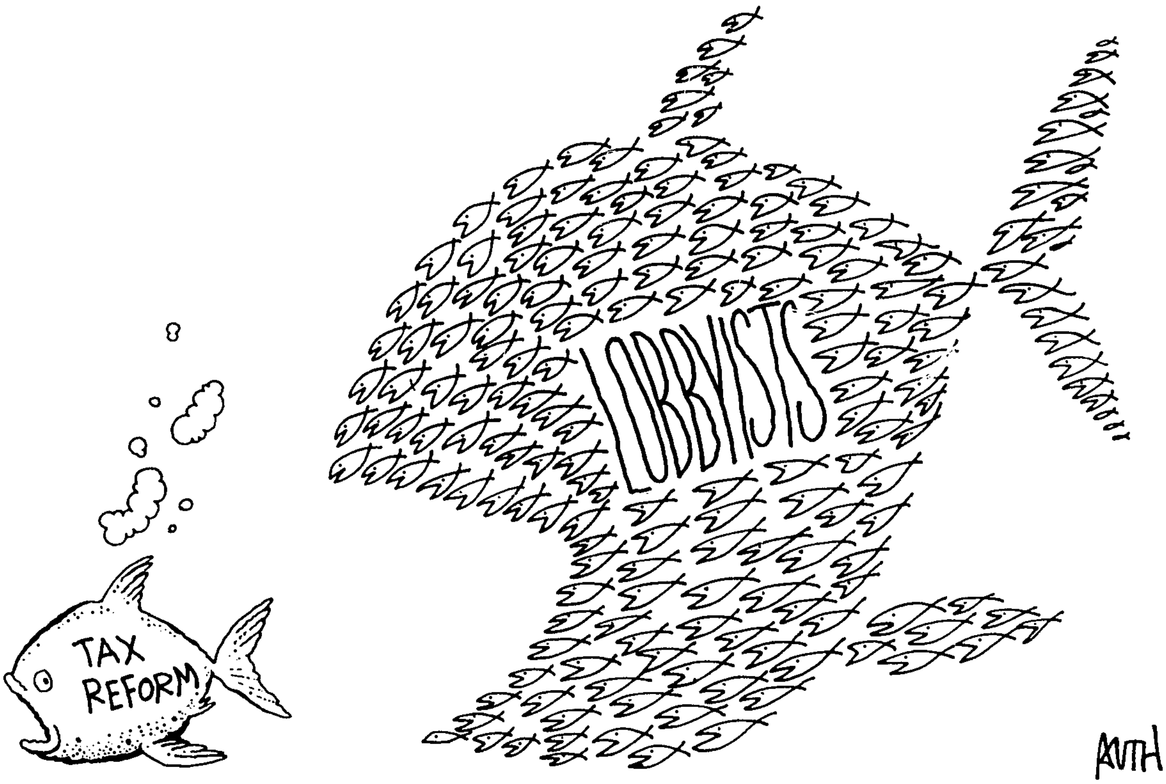
A Spending Program by Another Name

Critics of this growing list of tax expenditures believe that in most cases the incentives do not have the intended effect. Even when they do, the policy goal accomplished is not worth the revenue sacrificed, not to mention the complexity they add to the tax code. Critics feel that the current system favors the clever and the sophisticated, people who have the time and the inclination to search through the IRS laws for special clauses from which they can benefit.

If certain goals are worthwhile, there are other ways of accomplishing them. As the tax expenditure process currently stands, it amounts to a government spending program, but one that is not so carefully scrutinized each year as the appropriations budget. As Senator Bradley said, "It is in the appropriations process that we decide whether the government should spend money on energy development, railroad beds, education, and timber reforestation. That's a process we go through every year with rigorous review. The problem with tax deductions and exemptions is that there is no public scrutiny to determine what we receive for all this spending."

Advocates of tax simplification point out that eliminating certain deductions doesn't mean that Congress is turning its back on a particular need. The same goal could be accomplished by different means. If, for example, the deduction for charitable contributions were eliminated, Congress could enact a spending program to provide matching grants for private contributions to charitable organizations.

There are various arguments, then, for the elimination of tax loopholes. The economy would be better off because tax



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considerations would play a smaller role in the allocation of resources. The IRS itself would be better off because the costs of administration and compliance would be reduced. Most of all, taxpayers would be better off if most of the supplementary schedules were eliminated, and the tax returns were reduced to a brief one-page form. The only losers would be the accountants and lawyers who have been making a handsome profit by identifying loopholes, and helping their clients slip through them.

This is why many people have concluded that most loopholes should be closed. In the words of Joseph Pechman, a tax expert at the Brookings Institution, "I hope Congress makes it clear that it will wipe the slate clean, letting nothing but the most meritorious deductions and exclusions stand."

Both Sides Now

So these are the two sides in the battle over tax shelters. On the one hand are those like Joseph Pechman, who would "wipe the slate clean." On the other, there are those who argue the merits not just of certain tax privileges for special purposes, but more generally of using exemptions and deductions as a way of encouraging action in the public interest.

Defenders of tax incentives point out that legislating in this way has several advantages. In contrast to the bureaucratic red tape that is characteristic of so many government efforts, tax expenditures are an efficient and effective way of accomplishing specific goals. Like others who take this position, columnist George Will defends tax incentives as a means of doing what government does well. "Government is not efficient at providing goods and services," he wrote. "But it is good at writing checks and at providing incentives that cause self-interested persons — that is, almost everybody — to behave in certain ways." Will concluded that "unlike many government social programs, tax incentives often achieve their intended effect. They alter behavior on a large scale for the advancement of chosen goals."

Part of the debate, then, is about whether tax deductions provide an effective tool for accomplishing certain goals. Another part of the debate is about which objectives — such as providing incentives for investment in certain areas, or encouraging charitable contributions — deserve public support. Beyond that, the question has been raised whether it is politically possible to abolish the deductions and exemptions that now provide tax advantages to so many.

To this last question, those who would eliminate tax loopholes have a simple and direct reply. If they were repealed, the federal government could collect the revenue it needs at much lower tax rates — rates that would be to almost everyone's advantage. In Senator Bradley's words, "Every loophole repeal must be considered in light of the lower rates that the package makes possible. The pain of giving up a tax benefit can be more than offset by the lower rates that come in the bargain."

One of the issues we have been examining is whether it is fair to use tax shelters to lighten the tax burden for certain individuals and specific purposes. In the next section, we turn directly to the matter of how the tax burden is distributed.

3

Progressive Intentions

"For 75 years, the tax system has been based on the principle that citizens who are able to pay more should be expected to pay higher rates. Is it better for most people to pay roughly the same tax rate?"

When pollsters ask the American public whether the tax system is fair, they get a clear and consistent response. Early in 1985, for example, an ABC/Gallup poll asked people if they feel that "the present system benefits the rich and is unfair to the ordinary working man or woman," and nearly three out of four people agreed. Moreover, 80 percent agreed that "I wouldn't complain about the amount I pay in taxes if I thought the rich were paying their fair share." When most people think about fairness, in other words, they think not only about how much they pay, but also about how much they pay relative to everyone else.

Given this widespread sentiment that the wealthy are not paying their fair share, one would expect tax reformers to advocate higher tax rates for the wealthy. After all, each of the reform proposals under consideration promises a fairer system. One of the leading reform plans, in fact, is called the "Fair Tax."

Yet, that is not the case. For all their differences, the main tax reform plans are similar in one important respect. While they would distribute the tax burden more equitably within each income level, they would not redistribute the tax burden among families at different levels. In other words, the tax rates of wealthy Americans would be no higher than they are under the current system.

Our main task in this section is to ask how the tax burden should be distributed so that everyone bears a fair share. Is it better for most people to pay roughly the same tax rate or for people at different income levels to pay quite different rates? To address that question, we need to examine how the tax burden is currently distributed, and the effects of the proposed reforms.

The Progressive Era

One of the basic choices in designing a tax system is which principle the system follows. In a progressive system, as income rises so does the percentage of income taxed. In a regressive system, taxes fall more heavily on those with less income. And in a proportional system, people at all income levels are required to pay the same percentage.

Ever since the income tax was put into effect in 1913, it has been based on the progressive premise that the wealthy should pay higher tax rates. This is the principle that Adam Smith, noted Scottish economist, enunciated in 1776 in *The Wealth of Nations*. Citizens, he wrote, should pay tax in relation to their ability to pay. The wealthy should be expected not only to pay more in taxes, but also to pay a higher percentage of their earnings in taxes. The congressional committee that wrote the original tax code in 1913 took that principle to heart. The new federal income tax, said one committee member, "is levied according to ability to pay, and it would be difficult to devise a fairer tax."

In the 72 years since then, tax rates have been modified

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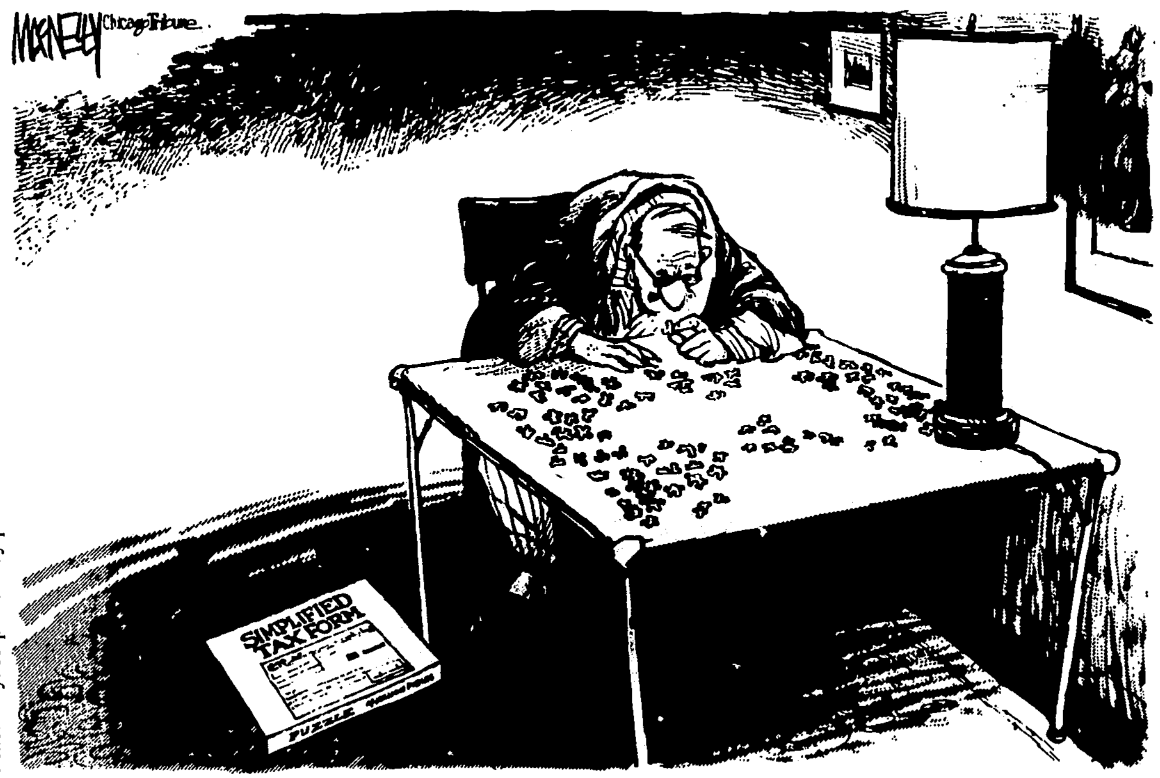
on many occasions, reflecting shifting perceptions of what is fair, as well as changing revenue needs. Despite these variations in tax rates, the principle of progressivity has remained intact. Judging from the graduated rate schedule of the IRS booklet, it would appear that the tax system is sharply progressive. The rate structure consists of 14 different brackets that are tied to people's ability to pay. The tax rate for married couples ranges from 11 percent for families with modest income to a maximum of 50 percent on that portion of family income exceeding $162,400. (Single taxpayers reach the 50 percent tax bracket at $81,800.) The rate schedule expresses a fundamental value, that people who can afford to pay higher tax rates should be expected to do so.

However, the tax system is less progressive than it appears. Because upper-income families typically use various deductions to lower their taxable income, the system loses much of its progressivity. In fact, the wealthiest taxpayers pay an average tax rate of about 30 percent. But while the average tax rate of the nation's wealthiest taxpayers is not so high as it would appear if you look at the graduated schedule, they still pay a disproportionately large amount of all taxes. America's wealthiest families — those whose household income exceeds $200,000 — comprise just two-tenths of 1 percent of all American families. Yet this group, in 1984, paid almost 10 percent of all the income taxes.

When other taxes are taken into account, the overall burden is even less progressive. In addition to federal taxes, many pay a local sales tax and a gasoline excise tax. Forty-five states require residents to file a state income tax, and most home owners are assessed for local property taxes. In addition, Social Security taxes are deducted from our paychecks. Each of these taxes, especially the Social Security tax (which in 1985 is not assessed on income over $39,600), is regressive. The burden of state, local, and Social Security taxes falls disproportionately on those at lower income levels.

When taxation at all levels of government is considered, the system is only slightly progressive. According to Joseph Pechman, "When you take all the taxes together and compare



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that with total income, the top 10 percent of the population pays less than 30 percent of their income in taxes, and the bottom 10 percent pay more than 20 percent." In other words, people at quite different income levels currently pay roughly similar tax rates.

A "Modified Flat" Tax

Since the burden is distributed in a less progressive manner than the tax rates suggest, you might wonder why the tax codes are not rewritten to correspond to what is actually happening. Rather than imposing steeply progressive taxes and then allowing so many exemptions and deductions, we could take the more direct course of eliminating most tax shelters and levying roughly proportional taxes on the entire population.

That is the idea behind various proposals for a flat or "modified flat" tax. The advocates recognize the distribution of the tax burden under the current system, and propose that we adopt it as our official tax policy.

Each of the three major proposals that were under consideration early in 1985 — the Treasury proposal, Bradley-Gephardt, and Kemp-Kasten — would distribute the tax burden in roughly the same way it is currently distributed. Middle-income families (those with income between $14-35,000) pay an average federal tax rate of 10.3 percent under the current system. According to an analysis of these proposals by Data Resources, Inc., under Bradley-Gephardt, they would pay 9.8 percent; under Kemp-Kasten 11.6 percent. If either of these plans is put into effect, families in the $57-85,000 range would pay on average almost exactly what they are currently paying — 17.4 percent of their gross income. Only at the upper reaches of the income scale would these plans substantially change the tax burden. Among families earning $142,000 or more per year, average tax rates are now 37 percent. Under the Treasury proposal, they would be 27 percent; under Bradley-Gephart, 25 percent; and under Kemp-Kasten, 20 percent.

Characterized as "modified flat" taxes, these reform plans are in fact moderately progressive. Less progressive than our current tax code, they still impose somewhat higher tax rates at higher income levels. Bradley-Gephardt, for example, would impose an average tax rate of about 10 percent on middle-income families in the $14-35,000 range. It would impose a tax rate of slightly over 20 percent on families with income from $85-$142,000, and a rate of 25 percent on families at higher income levels.

Is It Fair?

The question is whether these proposals are fair. Essentially, two quite different kinds of fairness are at issue. The first question is whether the taxes you pay are the same as those paid by other families at the same income level. Proponents of the three major tax reform plans argue that in this respect each of these plans is more equitable than the current system. At every income level, some people would pay less under these alternative plans while others (mainly those who now get substantial benefits from shelters) would pay more. The overall effect of removing most exemptions and deductions would be to guarantee that families who earn similar incomes are taxed at the same rate.

The second question — the one that we will be focusing on — is whether these plans fairly distribute the tax burden among families at different income levels.

Is a tax system that is only moderately progressive fair? To put the current proposals in perspective, let us examine the arguments for a flatter tax, and for a progressive system.

Flat Is Fair

Proponents of a flatter tax system feel that it is not only simpler to impose roughly similar rates on the entire population, but fairer to do so. When people at all income levels pay taxes at the same rate, families at the upper end of the income scale still end up paying a much higher tax bill. "Fairness is requiring a person or household with ten times as much income to pay ten times as much in taxes, which is what a flat rate does," wrote economist Paul Craig Roberts, former assistant secretary in the Treasury Department. "No one can prove that fairness is requiring a person with ten times as much income to pay twenty times as much in taxes."

While this is the most straightforward rationale for a flat tax, it is by no means the only one. Proponents of a flat tax feel that since prosperity is in everyone's interest, it follows that the tax rates which are most conducive to economic growth are in the public interest. They feel that it makes little sense to impose steeply progressive taxes that heavily burden well-to-do people. Lowering our own tax rate by imposing a heavier burden on those with a greater ability to pay may be expedient. But, as President Reagan put it in an address this past April, "in meeting concerns for fairness, we must not jeopardize economic growth." If highly progressive taxation is used as the instrument of egalitarian policies, it is bound to have an adverse effect on people's incentive to save, work, and start new businesses.

Any tax which substantially increases the after-tax income of the well-to-do family is likely to increase their savings. That has important consequences for the economy as a whole, since the chief savers are upper-income families and corporations. The first requirement for prosperity is the availability of capital.

President Reagan's Tax Plan

In May, six months after the Treasury Department released its tax reform plan, President Reagan presented his own proposal. Similar in several respects to the Treasury proposal, it allows more deductions for individuals. Here is a summary of the chief elements of the proposal which promises to be the centerpiece of the debate.

- The personal exemption and standard deduction would both be raised. A $2,000 exemption would be allowed for each taxpayer and each dependent. The standard deduction, now $2,300, would rise to $3,000, thus easing the burden on low-income families.
- There would be three income tax brackets for individuals: 15, 25, and 35 percent. Because the maximum rate would be lower than its current level of 50 percent, upper-income taxpayers who have not claimed substantial deductions would benefit.
- Corporations would pay more of the tax burden. Even though the top business rate would be lowered from 46 to 33 percent, corporate tax payments would increase by approximately 9 percent because of the elimination or reduction of heavily used deductions.
- Several key deductions for individuals would be retained or expanded. Mortgage interest would be deductible, although only for one's principal residence. Medical costs would be deductible to the same extent that they are now. Taxpayers and their spouses would each be able to put up to $2,000 in a tax-deferred individual retirement account.
- Other personal deductions would be reduced or cut altogether, and certain types of income which are not currently taxable would be taxed. Unemployment compensation would be taxed. The first $10 of fringe benefits received each month would be taxed. And state and local taxes would no longer be deductible, which would raise the tax burden for residents of areas with high state or local taxes.
- Certain tax shelters that are commonly used by business would become less advantageous. The oil and gas depletion allowance, real estate depreciation deductions, and deductions for entertainment and meals are among the write-offs that would be scaled down or eliminated entirely.

Who Wins, Who Loses?

Advocates of the major tax reform proposals often assert that most Americans can expect to benefit from tax cuts. But some people in each bracket would end up paying more. By asking the following five questions, you can assess a proposal's likely effects.

What is the standard deduction?

The standard deduction (or the zero bracket level) is the amount that everyone can earn before they start paying taxes. Currently, that amount is $2,300 for single filers and $3,400 for joint filers or qualifying widows and widowers. The Treasury bill proposes to change those figures to $2,800 and $3,800, while the Bradley-Gephardt bill would raise them to $3,000 and $6,000, respectively. If you have a low income, you can expect to benefit from a plan which raises the standard deduction.

How much is the personal exemption?

The personal exemption is the amount you are allowed to subtract from your income for yourself, your spouse, and your dependents. Currently, you can also take an exemption if you are blind or over 65. The personal exemption is included in the tax code to decrease the tax burden on larger families. Under the present system, each personal exemption is $1,000. Several of the reform proposals would raise this amount significantly. If you have a large family, you can expect to benefit from a plan that raises the exemption for dependents.

Which deductions are allowed?

There are substantial differences among the proposals about which expenses taxpayers are allowed to deduct. The Kemp-Kasten bill, for example, would eliminate most deductions and retain just a few such as home mortgage interest and charitable contributions. The DeConcini plan would eliminate all deductions. If your taxes are currently substantially reduced through deductions, you will pay more if those shelters are eliminated.

What is considered taxable income?

Several of the current proposals would redefine what is regarded as taxable income. Some proposals, for example, would tax fringe benefits and Social Security benefits over a certain amount. If you derive substantial income from such sources, you can expect to pay more if they are considered taxable income.

What is the proposed tax rate for your income level?

As you determine what rates are proposed in a particular plan, the important figure is the effective tax rate, which tells you what percentage of your income you pay. If the plan lowers the rate for your income bracket, you stand to gain.

In this country, where the personal savings rate is quite low, sufficient capital is by no means to be taken for granted.

A second requirement for prosperity is sufficient incentive to additional work and innovation. "When someone is considering starting a new business, learning a new skill, investing in stock or taking a second job," wrote Representative Jack Kemp in 1979, "what matters is not the average tax on his or her earnings, but how much of any added earnings he or she will be allowed to keep. Without added earnings, there can be no added production. And without added production, there can be no growth."

Consider from this perspective the effect of the 50 percent top rate in our current tax code. For a family in that bracket, half of every additional dollar they earn goes to Uncle Sam — and that reduces their motivation to work more, produce more, and invest more.

One of the chief arguments for a flat rate is that it relieves people at all income levels from having to consider whether additional effort and income will push them into a higher tax bracket — thus reducing the value of what they are paid for their effort. If everyone pays taxes at the same flat rate, there is no reason to wonder how much tax will be due on an hour of overtime, a cost-of-living raise, or earnings from a second job. It will be exactly the same rate paid on all previous income.

For these reasons, proponents of a flat tax believe that it will stimulate the economy, and thus increase tax revenues. The people who take this position recall what happened as a result of the Kennedy tax cuts, when as part of an across-the-board tax reduction the top marginal rate was reduced to 70 percent. It is not coincidental, in their view, that what followed was an expansionary surge in the economy.

As economist Jude Wanniski wrote, "Why not lower tax rates for the rich? They will thus be enticed back from their yachts and once again assemble widget plants in New York City, with tax revenues flowing to Washington, Albany and City Hall not only from them, but also from those who would be usefully employed in widget-making."

There is a final argument for reducing the maximum tax rates. To do so would reduce the incentive to avoid taxes. From this perspective, a compelling reason for not trying to "soak the rich" is that it will not work. If taxes are considered to be too high, taxpayers try to avoid them. As a result, the government may actually get less revenue from a high tax than it would if lower rates were in effect. That was Andrew Mellon's point when, as secretary of the treasury in the Coolidge administration, he sought a reduction of the top marginal rate to 25 percent. In Mellon's words, "The history of taxation shows that taxes which are excessive are not paid. The present high rates of surtax are bringing in less revenue to the government each year. Large taxpayers are avoiding taxable income by the many ways which are available to them."

When an untaxed dollar is worth far more than one that is

Len Boro—*Phoenix Gazette*, Ariz./Rothco

subject to taxation, there is a real incentive to noncompliance. In the eighteenth century, heavy customs duties made England into a nation of smugglers. Today, some feel, marginal tax rates of 50 percent are responsible for making America into a nation of tax evaders.

In summary, "soaking the rich" is not only unfair and damaging to the economy, it is unworkable as well. It discourages productive economic activity and encourages contempt for the law. So a flat tax which imposes the same tax rates on everyone makes good sense and sound policy.

Against the Flat Tax

Others, particularly those who emphasize equality over economic efficiency, take quite a different position. They feel that it is desirable to eliminate most tax shelters so that actual tax rates are nearer to the intention of the tax code. But, regardless of what happens on that front, they believe that a strong argument can be made for a progressive tax system.

The experience of the past several decades does not support the assertion that a graduated tax system with a top rate of 50 percent is inconsistent with prosperity. Over the years, a progressive tax system has not harmed the American economy. Indeed, throughout the rapid growth years of the 1960s, tax rates were substantially higher than they are today. During that decade, the maximum marginal tax rate at one point was as high as 91 percent, and was never lower than 70 percent. Just as a progressive tax code has not prevented prosperity in our past, neither have progressive taxes been the enemy of prosperity abroad. In fact, several nations that have the highest postwar growth rates achieved those rates with heavier tax burdens than ours, and more progressive tax codes.

The people who oppose a flat tax believe that the system can be simplified without forfeiting its progressive aspects. The complexity of the current system results mainly from proliferating exemptions and deductions, and the various forms required to claim them. There is nothing inherently complex about graduated rates.

Those who want a more progressive tax system feel that it is dangerous to accept the principle of a flat tax in exchange for the promise that most tax shelters — the deductions that provide many benefits for well-to-do people — will be eliminated. While some recall the economic boom that followed the Kennedy tax cuts, critics of a flat tax recall something else about that episode. At the time, a substantial reduction in the top tax rate was offered as a way of sweetening the deal in order to facilitate the removal of tax shelters that mainly benefited upper-

"Is it better for most people to pay roughly the same tax rate, or for people at different income levels to pay quite different rates?"

income taxpayers and businesses. The tax cuts went through, providing a bonanza for the wealthy. But the reform that would have removed most tax shelters was abandoned by President Kennedy and finally rejected by Congress. And that is why the critics of a flat tax conclude that this is a dangerous bargain, and one which might backfire.

Advocates of a progressive tax system think we should be discussing how we feel about equality. Having decided at the outset that all people are self-evidently created equal, Americans have spent two centuries reflecting on this topic. There are various ways in which income can be redistributed — by subsidies such as welfare benefits, by publicly funded programs such as Medicare and Medicaid, or through the creation of new jobs. But tax reform is the most direct way of redistributing income. That the tax system has not recently functioned as a device for redistributing income from rich to poor does not mean that it could not serve that purpose. Those who favor a more progressive tax system feel this is one of the fundamental things that the tax system should do.

According to the Census Bureau, the number of Americans officially classified as poor rose from 24.5 million in 1978 to over 34 million in 1982. This represents 15 percent of the population, the highest poverty rate in 17 years. Over the same period, according to the congressional Joint Committee on Taxation, while the overall tax burden (including Social Security taxes) for the richest fifth of the nation's citizens declined slightly, taxes for the poorest fifth increased — from 9.7 to 11.9 percent. This is what strikes the proponents of a more progressive system as unjust. At a time when the number of impoverished Americans is increasing, so are the tax rates for those at the low end of the income scale.

Our first concern, they feel, should not be to use the tax system to provide greater incentives to the wealthy, but to use it as a tool for improving the condition of the poor. As things stand, the grinding poverty that many Americans experience is an incentive to crime, addiction, and despair — things that are undesirable for the poor as individuals and for us as a society. Proponents of a redistributive tax system favor higher personal exemptions as a way of relieving the tax burden of the poor. They also favor a more progressive system across the board, so that families with modest income are presented no more than a modest tax bill.

If more progressive taxes were imposed, the wealthy would no doubt argue that they should not be made to share so much of their income, and that such a system poses a threat to anyone who hopes to become wealthy. They might insist that the government has no right to interfere with the pursuit of wealth.

To this last point, those who favor redistributive taxes have a simple reply. A democratic society has every right to use the tax system to achieve greater equality. Considering its importance, the most surprising thing is that the public has not long since insisted upon doing just that.

And that is why some people strongly oppose flatter taxes. For three-quarters of a century, this nation's tax system has been based on the principle that citizens who are able to pay more should be expected to pay higher tax rates. The flat tax, they feel, represents a step backwards, a retreat from the principle of redistribution.

Should the Burden Be Shifted?

All of us would like our own taxes to be reduced, for the same reason that we would like the price tag of anything we buy to be as low as possible. But should the burden of individual income taxes — which last year came to $296.2 billion — be shifted?

Since most people define as fair any proposal that lowers their own tax rate, no reform is likely to meet universal approval. Any system will be criticized by people of modest means for its failure to redistribute wealth, and by the wealthy for the disincentives it creates.

Those who feel that the wealthy are not currently paying their fair share want the system to be more progressive. Others find nothing wrong with a certain amount of inequality, and defend it for its uses. As George Will put it, "A society determined to have economic growth must provide rewards for the persons most proficient at generating wealth. That means inequality. A just society is not one in which the allocation of wealth is equal. Rather, it is one in which inequalities are reasonably related to reasonable social goals."

There is, of course, no definitive answer to the question of how these considerations should be balanced, or whether the tax system should be used to redistribute income. This is what the debate is about.

4

Beyond the Income Tax

> "The federal tax system currently relies heavily on the individual income tax. Should more of the tax burden be placed on other revenue sources?"

In 1984, the revenue raised by the federal government from all sources amounted to $666.6 billion, which is a far cry from the $4.5 million collected during the first three years of the new republic. In fact, it wasn't until the young nation was into its third year that Secretary of the Treasury Alexander Hamilton hired a full-time tax collector. But even the modest taxes that were levied two centuries ago provoked occasional outrage. They also provoked a discussion which continues to this day about how best to pay for the cost of the public sector. One of the fundamental questions, then and now, is what will be taxed.

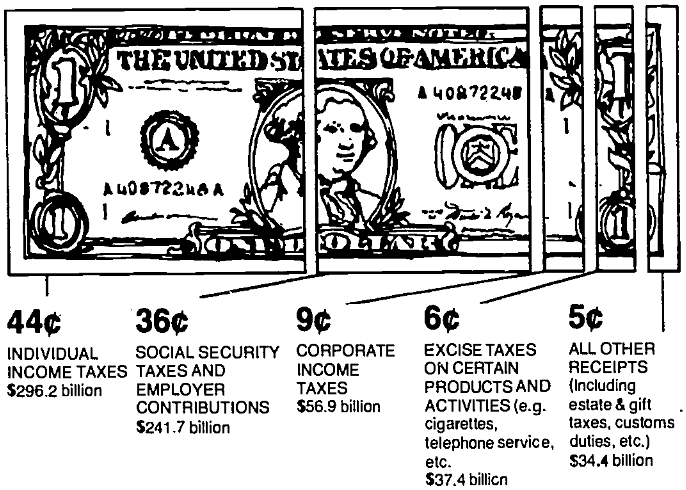
When federal taxes are mentioned today, the first thing that comes to mind is the individual income tax, and for good reason. It is the largest deduction from our wages and the largest single source of federal tax receipts. But it hasn't always been this way. Until early in this century, the individual income tax was not a regular part of the federal revenue system.

Throughout the 1800s, most federal revenues came from stiff tariffs on European imports, which also protected the nation's infant industries against foreign competition. By raising revenues with a tariff, government officials were able to placate strong anti-tax sentiments. Tariffs were first proposed by Thomas Jefferson, who argued that they would be the best revenue source for a nation that had just fought a war prompted partly by anger over excessive taxation. "The tariff falls exclusively on the rich," said Jefferson. "In fact, the poor man who uses nothing but what is made on his farm or by his family, or made within the United States, pays not a farthing of tax to the government."

"I'm sorry about this, but I'm afraid I just can't wait till April 15th."

WHERE THE 1984 TAX DOLLAR CAME FROM

$666.6 billion



Office of Management and Budget, February, 1985

"Far from being a fair tax, a corporate tax is a hidden tax which the public eventually pays in the form of higher prices."

In the nineteenth century, the government also tapped several minor revenue sources, such as an excise tax that was imposed on whiskey, sugar, tobacco, carriages, the slave trade, and other transactions. In combination, these sources produced enough revenue to cover the modest cost of running the government.

Prompted by a series of protests against raising revenues from sales taxes and tariffs, the income tax was introduced as a permanent feature in 1913. At first it was a class tax, imposed on a small number of wealthy Americans. It was not until World War II that it became a mass tax and a major source of revenue. As the government's role expanded in the postwar period, the personal income tax grew apace. By 1955, personal income taxes and Social Security taxes accounted for 45 percent of the government's revenues. Over the next two decades, and particularly in the 1970s as inflation pushed more and more people into high tax brackets that were originally intended only for the wealthy, Americans were asked to pay an increasing percentage of their income in federal taxes.

Today, the personal income tax is the source of 44 percent of the government's revenues. As the government has come to rely increasingly on this tax, there has been increasing sentiment that too much of a burden is being placed on this pillar of the revenue system.

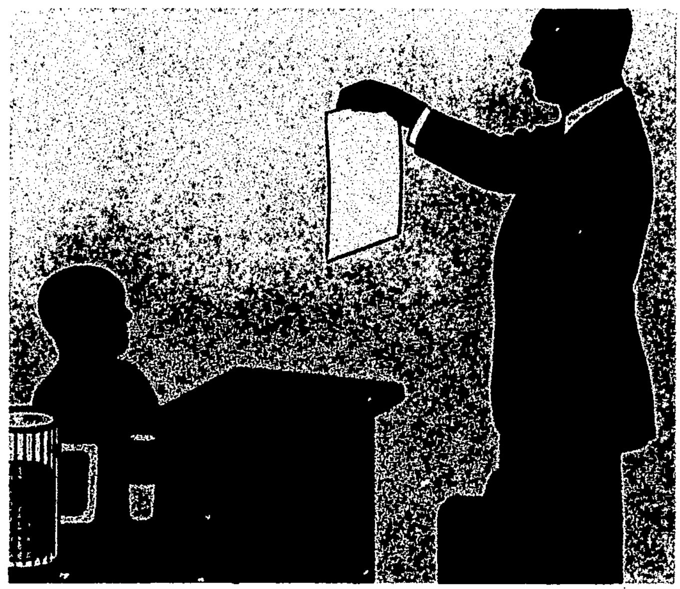
There are, of course, other revenue sources that could supplement the income tax, and there appears to be substantial public support for several of them. Recent polls have found strong support for imposing higher corporate taxes. And there is increasing interest in a national sales tax.

The question is what mixture of revenue sources the government should rely on. Some taxes that might provide additional revenue — such as higher "sin taxes" on alcohol and tobacco — are simply too small to make a difference. But two revenue sources other than the individual income tax figure prominently in the current debate on tax reform. Each of the reform packages would increase corporate taxes. A second revenue-raising alternative in which there is recent interest is the creation of a federal consumption tax. Both proposals should be considered on their merits.

Corporate Taxes

It wasn't long ago that the corporate tax produced a substantial percentage of all federal revenues. Established in 1909 as a 1 percent tax on corporate profits in excess of $5,000, the corporate tax rate rose dramatically over the next four decades, reaching a maximum rate of 52 percent in 1950. At that point, corporate taxes produced about a third of all federal revenues.

In principle, things aren't much different from that today. The top corporate tax rate is 46 percent, with graduated rates ranging from 15 to 40 percent on the first $100,000 of taxable income. However, actual rates are typically far lower than that.



First published in *Time* Magazine. Gary Billout © 1984

While effective tax rates for individuals have risen over the past three decades, the effective rates paid by corporations have declined. Corporate taxes now account for only about 8 percent of federal revenues.

The story here is much the same as it is with personal taxes. The reason why corporate taxes — which on the average amounted to 13 percent of profits in 1982 — are much lower than the maximum corporate rate of 46 percent is that many companies take advantage of deductions and exemptions that were designed by Congress as incentives to economic growth.

As a result of those tax preferences, there are large differences in the taxes paid by various firms. Companies such as IBM pay a tax rate of nearly 30 percent on their profits. Thanks to loopholes and incentives, other corporate giants pay little or nothing in taxes. For example, because of its ambitious capital spending program, General Electric paid no Federal income taxes from 1981-1983. In 1984, despite revenues of almost $30 billion its tax bill came to only $185 million.

For every dollar corporations paid in taxes in 1984, loopholes enabled them to avoid $1.42. Each dollar deducted from corporate tax obligations is a dollar that has to come from some other source, most likely from the pockets of individual taxpayers. This has prompted widespread resentment, and proposals to assess a minimum tax on profitable corporations. The Treasury proposal advocates the further measure of increasing corporate taxes by 25 percent. In the words of Treasury Secretary James Baker, "There's no way to make the tax system fair to individuals without raising business taxes. It's that simple."

Soon after the Treasury Department's proposal for higher corporate taxes was announced last November, the President expressed certain reservations about imposing higher taxes on the nation's businesses, saying that "I would have to be convinced of the need to do that."

"There's no way to make the tax system fair to individuals without raising business taxes. It's that simple."

—James Baker

For many people, the argument for higher corporate taxes is both compelling and self-evident. If individuals with modest incomes are expected to pay some 20 percent of their income in federal taxes, it is only fair that hugely profitable corporations should be expected to do at least as much. The existing system appears to be a blatant example of favoritism for those with political clout, and the legal and financial resources to get what they want.

But industry spokesmen are eager to explain why corporate taxes should be lowered, not raised. Essentially, their answer to advocates of higher corporate taxes is that things are not as simple as they appear. Far from being a fair tax, a corporate tax is a hidden tax which the public eventually pays in the form of higher prices.

Consider how higher taxes affect a typical firm. Higher taxes increase the cost of doing business. The company might respond by dismissing workers, lowering wages, or raising its prices. If this last option is chosen, higher taxes would mean

Should Employee Benefits Be Counted as Income?

When people think of their income, what normally comes to mind is the wages they receive. Most often, they don't regard as income the value of fringe benefits such as health and dental coverage, life insurance, or pension plans. Under the current IRS laws, such fringe benefits are not considered as income, and not subject to taxation.

The practice of excluding the value of fringe benefits from taxable income has been called into question recently. Why, some are asking, shouldn't fringe benefits be regarded just like the noncash benefits people get as a result of trade or barter, which are taxable?

Those who propose to tax employee benefits feel that two problems result from exempting them from taxation. First, it isn't fair to ask two workers to pay the same taxes, if one of them is better off because he receives more generous benefits.

Consider two workers who receive the same salary. One receives generous benefits, including full medical and dental coverage for himself and his family, while the other gets only a weekly paycheck. The first worker — whose medical coverage alone may be worth as much as $1,600 — is clearly better off. Yet both are expected to pay the same amount in taxes.

A second problem resulting from tax-exempt fringe benefits is that it makes such "perks" better than cash. This, in Senator Bill Bradley's words, convinces people to think of perks as "mad money," to take more of their compensation in fringes than they would if all forms of compensation were taxed. Consequently, over the past two decades, fringe benefits have become an increasingly important part of the total employee compensation package

The amounts at stake are substantial. The Joint Committee on Taxation estimates that the annual revenue loss from excluding employer contributions for medical insurance premiums came to $17.6 billion in 1984. The Treasury department estimates that taxing all employee benefits would produce an additional $80 billion in revenue by 1990.

However, this is a measure to which some are strongly opposed. Opponents of the proposal argue that health and pension benefits that are essential to people's welfare would be jeopardized if they were not exempt from taxation. This proposal represents, in their view, not just bad tax policy but bad social policy. In the words of AFL-CIO president Lane Kirkland, "These benefits meet specific national and economic goals. They are not frivolous 'perks' which reduce taxes for an elite few."

higher prices for shoppers. The impact would be regressive, with the sharpest consequences for low- and middle-income consumers.

Defenders of lower corporate taxes go a step further, pointing out that high taxes penalize capital investment and hinder economic growth. In response to the Treasury Department's proposal, Mobil Oil ran an ad that appeared in many national publications. Its message was that each dollar paid in corporate taxes is a dollar needed for modernization, that "higher taxes curb investment and derail the economy."

Critics regard these as misleading claims. Unconvinced that corporate taxes prevent firms from making adequate investments, they cite a recent study of taxes and investment patterns of 238 major corporations. The study concludes that the 50 companies which paid the lowest tax rates in the period from 1981-1983 actually reduced their spending on plant and equipment over that period, while the 50 firms with the highest taxes increased theirs. Moreover, in businesses such as the oil industry where some firms pay much higher taxes than others, the price charged by various firms at the gas pump is almost identical. It appears that the cost of higher taxes is not necessarily passed through to consumers. What firms charge for their products depends upon what the market will bear.

Differences over imposing higher corporate taxes concern these two issues, whether they will injure the economy by hindering investment, and whether their indirect effect is to push up prices, thus imposing a regressive tax that is less equitable than the income tax.

Some people are convinced that raising corporate rates is the most sensible and direct way to raise additional revenues. As tax expert Robert McIntyre points out, if corporate taxes were raised to the levels that prevailed during the economic boom of the 1960s, the additional revenue would substantially reduce the burden on individual taxpayers and help to close a huge budget deficit.

Others reply that since the real effects of higher corporate taxes are neither predictable nor direct, we would be better off looking elsewhere for additional revenues, perhaps to a national sales tax.

Taxing Consumption

If raising corporate taxes represents one way to generate substantial revenue, imposing a federal consumption tax — a tax on the goods and services we buy — represents another. Since 45 states and many local governments already impose a sales tax, this is a proposal that has the virtue of familiarity. It is also a tax that is widely used abroad. Most of the European countries rely on consumption taxes to support part of the cost of national government. In France, the government raises almost half of its revenues with a value-added tax, one of several types of consumption tax. A recent Treasury study found that "the United

States stands almost alone among the developed nations in not levying a national sales tax."

Unlike some of the other revenue-generating proposals that have been put forward recently — such as additional excise taxes on cigarettes or liquor, or a national lottery — this is a powerful tool that could raise a great deal of money. It is estimated that a 3 percent federal consumption tax would raise some $50 billion. Some of its advocates recommend it as a supplement to the existing revenue system, while others regard it as a replacement for the income tax. In either case, it is a proposal that deserves serious consideration.

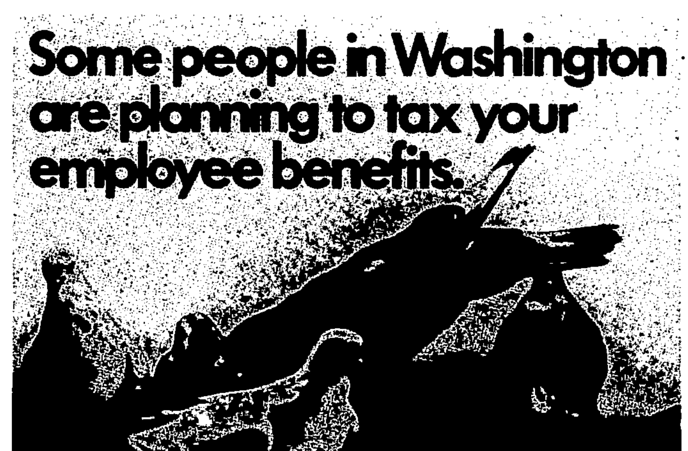
A national sales tax compares favorably to the income tax in several respects. Since a sales tax is paid by the consumer at the cash register, it is difficult to evade, simple to compute, and easier to administer than an income tax. Because of its simplicity, a federal sales tax would be widely regarded as fair. Moreover, since it is a tax on what people take out of the economy (consumption) rather than on what they put into it, this would promote savings. That should lead to lower interest rates and greater investment.

Like every other revenue source, however, a sales tax has certain disadvantages. It raises the price of commodities, and in doing so adds an inflationary pressure. Beyond that, it is a tax that state and local governments have already claimed as their own. Not unexpectedly, officials at both of these levels regard a national sales tax as an infringement on their tax base.

These are minor problems compared to the chief flaw of a sales tax. The major objection to such a tax is that it is regressive. It takes a larger percentage from those with lower incomes. When new revenue sources were being considered three-quarters of a century ago, discussion turned to the matter of whether a rich person consumes more tobacco, liquor, or other substances to which a sales tax applies, compared to someone of modest means. The answer, of course, was that people at different income levels consume roughly equal amounts of many products. So a sales tax poses a greater burden on people with less income. And this was the chief reason for not resorting to a national sales tax at the time.

Certain measures can be taken to make a sales tax less regressive. In many of the states that employ a sales tax, necessities such as food and medicine are exempted. The same measures could be taken with a federal sales tax. But making and enforcing the distinction between necessities and nonnecessities leads to complexities that rob the sales tax of its apparent simplicity. In the state of New York, for example, Prell shampoo is taxable but Head and Shoulders is not, since the latter product is intended to treat dandruff, which is considered a disease. For the same reason, while non-sterilized cotton is taxed, sterilized cotton is tax exempt.

Critics of a federal consumption tax believe that attempts to make this tax fairer would lead to the creation of subtle distinctions — and loopholes — similar to those that cause so much mischief in the income tax system. The overall result of introducing such a tax, they feel, would be a more complicated and less equitable system than the one we have now.



Courtesy — American Council of Life Insurance and the Health Insurance Association of America

In response to the proposal that employee benefits be taxed, several groups, such as the American Council of Life Insurance, have mounted efforts to oppose such a change.

So the debate over alternative revenue sources recalls the same alternatives and arguments that were discussed two centuries ago. Revenues can be raised by taxing what we earn, or what we consume. They can be raised directly by imposing a tax on income, or indirectly by imposing a tax on business. Perhaps the best solution is the one that members of Congress reached in 1913, when they decided that income is the most reliable measure of a person's wealth, and that a system relying mainly upon income tax is the best way of assessing a "fair share" of the cost of government.

Much has changed since these questions were first posed in the era of Hamilton and Jefferson, notably the amount needed to pay for the cost of government. But at least one thing remains the same. Because there is no ideal revenue source, we are left to choose among a number of flawed alternatives.

5

The Bottom Line

"What citizens need to ponder and debate is not just the principles that should guide tax reform but the compromises we are willing to accept."

So we return to the basic question posed by these plans for radical tax reform. What is the best way to carry out this fundamental task of government, to do it efficiently, and to make sure that various parties pay their fair share of the cost of government?

For most people, evaluation of any tax reform proposal begins with a calculation of self-interest. As taxpayers, we have a direct stake in the outcome. We would like not only a simpler system but also one that lowers our tax bill. The first thing we'd like to know about any reform proposal is how it affects the bottom line — the total federal taxes we owe.

The ongoing battle over tax reform is a game in which a dollar that is not paid by one party has to be paid by someone else. It is, in brief, a game in which there are winners and losers. For most people, a good tax reform package is one that lowers their tax rate by stripping away someone else's shelter.

It is understandable that discussion of tax reform should begin with a concern for self-interest. But it is highly undesirable for it to end there. The whole point of public debate about taxes is to arrive at a reasonable compromise, a bargain which is acceptable to many different parties and one that does not compromise fundamental values.

Three Choices

In this issue book, we have reviewed three choices that need to be made. The first is whether deductions and exemptions should be kept in the tax code as incentives for achieving certain goals such as economic growth and home ownership. Should the tax system be used strictly as a device for revenue collection? Considering the complexity that shelters add to the tax system, would the public interest be better served by eliminating them? As desirable as a simpler tax system would be, there is a price for achieving it. Many people would have to give up the tax advantages they currently enjoy.

A second choice concerns the matter of how the tax burden should be distributed among individuals, and here the choice is between two different conceptions of fairness. Congress could adopt a flat tax that takes the same fraction of everyone's income, which would make the tax code simpler but less progressive. Or Congress could impose a more progressive tax that would redistribute income, but with the inherent complexity of a system consisting of various tax brackets for people at different income levels.

A third choice concerns new revenue sources that might be tapped. Corporate taxes could be increased, which would relieve some of the burden that now rests on the individual income tax. But a corporate tax is an indirect tax, and there is a good deal of uncertainty about its eventual effect. Alternatively, a national sales tax could be imposed, but at the cost of placing a greater burden on those of modest means.

In making these choices it's easy to agree on principles such as fairness, efficiency, and simplicity.

The harder and more useful task is to decide upon trade-offs among these objectives. Which activities, if any, are so crucial to the public interest that they deserve special tax treatment, even if deductions and exemptions introduce more complexity into the tax code? What are we willing to give up in economic efficiency in order to achieve greater equality through a redistributive tax system?

Special Interests and the Common Cause

The ideal, of course, is a debate about the public interest that leads to some consensus about the components of a tax reform package which is fairer and simpler than the system we now have. But what has actually been happening since the Treasury Department announced its reform package last fall is that a great many groups have been mobilizing to protect their interests.

What it comes down to is whether a bargain can be struck that exacts a price from, and promises certain advantages to, almost everyone. Reaching such a bargain will be no easy task. Tax simplification is a fragile house of cards. If some groups insist upon retaining their loopholes, there will be a chorus of objections from the defenders of all the others who feel unfairly burdened.

That brings us to the other "bottom line" in the debate over tax reform, the question of whether those groups which stand to lose from tax reform will be successful in preventing it. "The real question," as House Ways and Means Chairman Dan Rostenkowski puts it, "is not so much whether the country needs tax reform, or whether most people want it. It is whether Congress can enact tax reform."

The current IRS rules are the result of pressures for preferential tax treatment to which members of Congress felt obliged to respond. As Joseph Pechman points out, the people who sit on the congressional tax committees — the Ways and Means Committee and the Senate Finance Committee — are some of the most senior and powerful members of Congress. They know the importance of responding to their constituents. And they know that the groups that have received favors are ready to defend their gains, and to threaten reprisals to elected officials who would take them away.

Tax preferences were not provided solely to the wealthy and the powerful. The beneficiaries of many deductions and exemptions are people of more modest means. They may not have well-organized lobbies to protect their interests, but they have numbers on their side. Few elected officials are willing to risk their wrath by proposing to eliminate their tax preferences. So there are some powerful forces standing in opposition to radical tax reform.

Finally, what citizens should ponder and debate is not just the principles that guide tax reform, but the compromises we are willing to accept to make reform politically feasible.

Victor Juhasz

For Further Reading

For a general treatment on tax policy and options, see Robert McIntyre's *Just Taxes and Other Options*, from Citizens for Tax Justice (Washington, D.C., 1983); and *A Citizen's Guide to the New Tax Reforms*, edited by Joseph A. Pechman (Totowa, New Jersey: Rowman and Allanheld, 1985). A more detailed account can be found in *Federal Tax Reform: The Impossible Dream?* by George Break and Joseph A. Pechman (Washington, D.C.: Brookings Institution, 1975).

For useful detail on the debate over a flat tax, see "Flat Tax: Hearings Before the Committee on Finance of the U.S Senate" (Washington, D.C.: Government Printing Office 1982).

Although slightly dated, *Taxation: Myths and Realities*, edited by George Break and Bruce Wallin (Boston: Addison-Wesley, 1978) provides a readable and comprehensive overview of tax issues. See also *Running for Shelter: Tax Shelters and the American Economy* (Washington, D.C.: Public Citizen, 1985).

Acknowledgments

Many people participated in the process of deciding upon this year's topics, discussing how they should be approached, preparing the materials, and reviewing their content. Once again this year, David Mathews and Daniel Yankelovich provided both guidance and support. Jon Kinghorn played an indispensable role in keeping the various parts of this far-flung network in touch with one another, and providing assistance of many kinds to the convening institutions and forum leaders.

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NATIONAL ISSUES FORUM

2. Taxes: Who Should Pay and Why?

Please answer these questions after you have attended the discussion or read the booklet. Answer them without reference to your earlier answers. Then hand in both reports to the forum moderator, or mail them to the Domestic Policy Association in the attached prepaid envelope. (In case no envelope is enclosed, you can send these pages to the Domestic Policy Association at 5335 Far Hills Avenue, Dayton, Ohio 45429).

PART I

For each item below, check the appropriate box to indicate whether it is something you favor or oppose.

	Favor	Oppose	Not Sure
1. Use income tax deductions to encourage people to own their own home, give to charity, and accomplish other social goals	☐	☐	☐
2. Grant income tax exemptions for people in special circumstances	☐	☐	☐
3. Provide preferential tax treatment to certain businesses and industries as an incentive to investment and growth	☐	☐	☐
4. Eliminate all income tax deductions for individuals	☐	☐	☐

1. Use income tax deductions to encourage people to own their own home, give to charity, and accomplish other social goals

PRO: Using income tax deductions enables the government to encourage people to spend their money in ways that benefit the whole society.

CON: The income tax should have only one purpose—to pay for what the government does.

2. Grant income tax exemptions for people in special circumstances

PRO: It is only fair that the blind, the disabled, and those with many dependents should pay less tax than those in good health or with no children.

CON: Those who earn the same should pay the same amount of tax, regardless of circumstances.

3. Provide preferential tax treatment to certain businesses and industries as an incentive to investment and growth

PRO: Economic growth is in everyone's interest; preferential tax treatment for certain businesses and industries enhances growth.

CON: Many preferences designed to promote growth don't have the intended result; instead, they end up as costly loopholes that burden everyone else.

4. Eliminate all income tax deductions for individuals

PRO: The idea has been abused to the point of excess; most of the deductions favor those in the highest income brackets.

CON: Providing incentives is one of the things the government does well. It is a way for the government to achieve social goals without directly interfering in the economy or people's lives.

PART II

Here are five types of tax systems:

a. A *very regressive* system taxes those who earn the least at substantially higher rates.
b. A *somewhat regressive* system taxes those who earn the least at slightly higher rates.
c. A *flat tax* system taxes everyone at the same rate, regardless of income.
d. A *somewhat progressive* system taxes those who earn the most at slightly higher rates.
e. A *very progressive* system taxes those who earn the most at substantially higher rates.

5. Which best describes what percentage of their total income people *actually pay* under the existing laws?

a. Very Regressive ☐
b. Somewhat regressive ☐
c. Flat ☐
d. Somewhat progressive ☐
e. Very progressive ☐
f. Not sure ☐

6. Which best describes the major tax reform proposals now being discussed in Washington?

a. Very Regressive ☐
b. Somewhat regressive ☐
c. Flat ☐
d. Somewhat progressive ☐
e. Very progressive ☐
f. Not sure ☐

PART II (Continued)

7. Which best describes what percentage of their total income people *ought to pay* in a fair system?

a. Very Regressive ☐
b. Somewhat regressive ☐
c. Flat ☐
d. Somewhat progressive ☐
e. Very progressive ☐
f. Not sure ☐

PART III

For each item below, check the appropriate box to indicate if it is something
a. we should *do now*
b. we should do *only if* taxes have to be raised
c. we should *not do* under any circumstances

	Should Do Now	Only If	Should Not Do
8. Should we require corporations to pay income taxes at rates that are at least as high as the rates paid by most American families?	☐	☐	☐

PRO: Some corporations make huge profits and pay no tax at all; a business that prospers should pay at least some tax.

CON: Raising corporate taxes only takes away money that would otherwise be invested or go to employees and stockholders, and thereby benefit everyone.

	Should Do Now	Only If	Should Not Do
9. Enact a federal sales tax with exemptions for certain necessities such as food and medicine	☐	☐	☐

PRO: In addition to being easy to collect, such a tax would be hard to avoid and would bring in substantial new revenue.

CON: Such a tax would be both inflationary and regressive, falling most heavily on low- and middle-income people.

PART IV

10. If the federal government had to raise taxes substantially, which would be a better way to do it — by increasing individual income taxes, or imposing a new national sales tax on purchases other than food?

Increase income taxes ☐
Impose federal sales tax ☐
Not sure ☐

11. Compared to other taxpayers, are the taxes you pay:

Too high ☐
About right ☐
Too low ☐
Not sure ☐

PART V

12. Did you participate in a DPA forum *last* year?
Yes ☐
No ☐

13. Did you (or will you) participate in DPA forums on other topics *this* year?
Yes ☐
No ☐

14. What is your zip code? .... ________

15. Which of these age groups are you in?
Under 18 ☐
18 to 29 ☐
30 to 44 ☐
45 to 64 ☐
65 and over ☐

16. Are you a man or a woman?
Man ☐
Woman ☐

17. If you could convey one message to the nation's leaders on taxes and tax policy, what would it be?

33

"I know no safe
depository of the
ultimate powers
of the society but the
people themselves;
and if we think
them not enlightened
enough to exercise
their control with a
wholesome discretion,
the remedy is not
to take it
from them, but to
inform their discretion
by education."

Th: Jefferson